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Directors and Officers Insurance—Issues to Consider Before Claim Arises

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Directors and officers (D&O) liability insurance remains a vital issue for companies and their directors and officers as potential sources of liability continue to evolve. More securities lawsuits were filed in the past year than in any year since 2008, reflecting increased liability risks surrounding mergers and acquisitions, and IPOs. And on September 9, 2015, the US Department of Justice (DOJ) issued the so-called "Yates Memo," which reaffirmed the DOJ's policy prioritizing enforcement against individuals allegedly involved in corporate crime. Beyond these headline-grabbing exposures, individual directors and officers at even relatively small companies and nonprofits remain subject to a variety of potential claims, from alleged fiduciary liability to shareholders, partners or donors, to claims by suppliers, customers or competitors.

The best time to ensure that sufficient D&O insurance offered on the best available terms is in place is before a claim arises. In advising clients on D&O insurance for almost two decades, we have seen many coverage claims that might have been resolved more smoothly, and in some instances more successfully, if more favorable terms had been negotiated when purchasing the insurance.

With the benefit of that experience, this paper identifies specific policy provisions to focus on when renewing or purchasing D&O insurance.

Coverage Periods

Insurers typically offer D&O insurance on a "claims-made" basis, which means a policy insures against liability arising from a claim first asserted against the insured during the policy period. D&O policies also require notice of a claim by a certain date, often the end of the policy period or thirty days thereafter. Taken together, the claims-made nature of D&O insurance and its notice requirements mean that for a claim to be covered by a policy, the claim must have been made *and* reported to the insurer during the policy period. This leads to several issues, all of which can and should be addressed when placing or extending D&O insurance.

First, while there may be business- or insurance-related reasons to switch insurers at renewal, insurer continuity carries significant benefits. If a claim arises, reasonable minds may differ on when it was first asserted, or whether the policyholder's prior "notice of circumstances that could give rise to a claim" was sufficient for the claim to relate back to when that notice was given. Such differences

may result in successive insurers each denying coverage, with the policyholder caught in the middle. Renewing the policy with the same insurer each year moots most such disputes.

Second, D&O insurance policies usually restrict coverage to claims arising out “wrongful acts” allegedly committed on or after the “retroactive date.” The retroactive date is typically the date on which the policyholder’s first D&O insurance policy with the insurer incepted. Accordingly, insurer continuity increases the time between that initial purchase and the current policy period, potentially also enlarging the scope of claims a renewed policy may cover.

Finally, many insurers offer extended reporting periods. If the D&O insurance is not be renewed following the policy period, then the extended reporting period provides a limited amount of “tail” coverage for claims alleging wrongful acts prior to expiration of the initial policy period. A typical D&O policy offers a one-year extended reporting period, but insurers can provide longer ones (for a price). A pre-negotiated option to purchase an extended reporting period of up to six years provides the directors and officers with the valuable protection in the event of a corporate sale or insolvency.

Who Is Covered

Another threshold requirement is confirming that the policy insures the intended corporate entities and individuals.

A policy typically covers an identified company and its subsidiaries, defined as any entity in which the insured organization has a 50 percent ownership interest, or the right to appoint the subsidiary’s board or management. Sometimes the insurance purchaser also wants to insure related companies that do not meet the subsidiary definition. One example could be a closely held company that has some common ownership with the insured company, but the insured company does not own the related company or have clearly defined rights of control. In this instance, one should seek a policy endorsement adding the related company as an insured, or explore a separate policy for the related company.

Individual insureds typically include “any past, present or future duly elected or appointed director or officer, or the holder of an equivalent position,” as long as any potential claim alleges wrongful acts committed while acting in their capacity as such. Companies wishing to insure other management-level individuals who are entitled to corporate indemnification, but do not fall neatly within this definition (*e.g.*, a “chairman emeritus,” members of an advisory committee to the board and/or management, in-house general counsel or an in-house risk manager) should state clearly to the insurer the intent to insure these individuals, and if necessary, obtain an endorsement identifying these positions as insured persons.

What Claims Are Covered

Generally, D&O policies provide at least three types of coverage. Side A or Executive Liability Coverage reimburses individual insureds for losses that are not indemnified by the company. Side B or Corporate Reimbursement Coverage reimburses the company for its indemnification of directors and officers. Finally, Side C or Entity Coverage covers claims made directly against the company; private companies enjoy coverage broader than that of public companies, which typically is limited to securities claims.

Beyond these basic coverage grants, policies can vary significantly in the scope of their coverage. For example, until recently, most policies defined a covered “claim” narrowly to include only written

demands for monetary or non-monetary relief, formal criminal or civil proceedings or government investigations initiated by a formal investigative order or notice targeting a specific insured. This definition restricted coverage for "informal" investigations of individual directors and officers, initiated by such measures as subpoenas, search warrants or requests for interviews and documents. Most D&O insurers now will expand their "claim" definition to include these informal investigative actions, but such expansion often must be requested specifically.

Another issue to address when a policy is purchased or renewed is "presumptive indemnification." Many policies presume that the insured company will indemnify the individuals to the fullest extent allowed by law, but if the company fails to do so for any reason other than financial distress, the individuals bear the adverse consequences. In this scenario, the coverage afforded the individuals typically is subject to the much higher Side B retention, meaning the individuals could be required to pay tens of thousands of dollars of defense costs or other loss before the insurer will begin to indemnify. This risk can be eliminated by deleting the "presumptive indemnification" provision, or modifying it to state that if the company fails to indemnify the insurer will defend and indemnify the individuals under Side A (typically with no retention) and the insurer's recourse shall be against the company, not the individuals.

The "presumptive indemnification" issue also can be eliminated by purchasing a separate Side A-only policy to complement the Side A/B/C policy. Other potential benefits of a separate Side A policy should a claim arise include the broadest available definition of "claim," elimination of most coverage exclusions (including the often troublesome "insured versus insured" exclusion), a separate insurance limit for the individuals that cannot be exhausted by the company's defense costs and losses, and no entanglement in bankruptcy proceedings should the company undergo financial distress.

Defense Costs

D&O policies typically do not impose duties to defend insureds. Instead, the insured retains control of the defense, and the insurer is obligated to pay the reasonable costs (that are usually part of—not in addition to—the policy's limit of liability). Several issues often arise in the claim context.

First, policies typically require the insurer to consent to defense-cost expenditures and the policyholder's selection of defense counsel. One way to avoid disputes in this area is to ask the insurer to preapprove by endorsement a panel of potential counsel. Such provisions do not obligate the policyholder to choose a firm on the panel, but they provide a significant benefit to the policyholder if it does so.

Second, insurers often condition reimbursement of defense costs on adherence to the insurer's billing guidelines, which may include a rate cap. Such guidelines may not reflect the markets in which the policyholder operates or litigates on a regular basis. Discuss this issue with the insurer before the policy is placed to determine how the insurer evaluates the reasonableness of defense costs. These discussions can lead to an endorsement setting forth the billing practices (*e.g.*, rates, timekeeping practices, administrative tasks, etc.) that the parties agree are reasonable (or unreasonable).

Third, D&O insurance policies historically indemnified defense costs on a "reimbursement" basis at the conclusion of the underlying claim, but in recent years most policy forms state expressly that the insurer shall "advance" costs while the claim is ongoing. This language can be improved further to require advancement within a specific time period after defense costs are incurred (*e.g.,* 60 or 90

days). Obtaining this commitment is particularly important for the individual directors and officers under Side A, as payment of substantial defense costs from their personal assets while awaiting reimbursement from the insurer may not be a viable option.

Conduct Exclusion

Insurers issue D&O insurance subject to various exclusions, some of which are negotiable.

A key exclusion bars coverage when the insured's conduct was dishonest, criminal, fraudulent, or the insured obtained an improper profit. This exclusion comes in several variations; a more favorable one requires the finding of intentional conduct by a "final adjudication," meaning an interlocutory finding or mere evidence of the conduct will not trigger the exclusion. Further, the exclusion may require that someone other than the insurer procure the finding, meaning that the insurer cannot try to obtain the necessary finding in a coverage dispute. Finally, the exclusion may state it is inapplicable to defense costs, which protects policyholders from having to repay defense costs even when a final adjudication bars coverage for indemnity. The policyholder-friendly variations should be requested if the insurer does not initially offer them.

Potential Company Bankruptcy

At no time is D&O insurance more important to covered individuals than when their company enters bankruptcy and cannot indemnify them. When the company is in financial distress, claims against the directors and officers become more likely, but the D&O insurance policy may be subject to the bankruptcy stay and the trustee's efforts to marshal the company's assets.

This risk can be mitigated by obtaining several important protections when purchasing a policy. Some insurers offer a bankruptcy-protection provision, which states expressly that the policy is intended to benefit the individual directors and officers, and in the event of a bankruptcy, the insureds agree to waive any stay and not to oppose the efforts of the insurer or any insured to access the policy proceeds.

Most policies contain an "order of payments" provision that requires the insurer to first pay non-indemnified defense costs and losses of the individual directors and officers, before paying the company's claim for reimbursement of indemnity payments, or the costs of direct claims against the company. But some policies state expressly that the insured company's bankruptcy does not relieve the insurer of its obligations to prioritize payments on behalf of the individual insureds.

Finally, the advantages of a separate Side A policy in the bankruptcy context bear repeating: Because the policy does not insure the company, it is not an asset of the estate. Moreover, Side A policies typically contain the favorable language exempting the policy from a bankruptcy stay and memorializing the individual directors' and officers' right to the policy proceeds should the company enter bankruptcy or a similar proceeding.

The Benefits of a Proactive Approach When Purchasing or Renewing D&O Insurance

The best time to address these issues is at the time of policy placement or renewal with the assistance of an experienced insurance broker and insurance counsel. A proactive approach when purchasing the policy can avoid delay, expense and an unsatisfactory result if a claim arises.

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